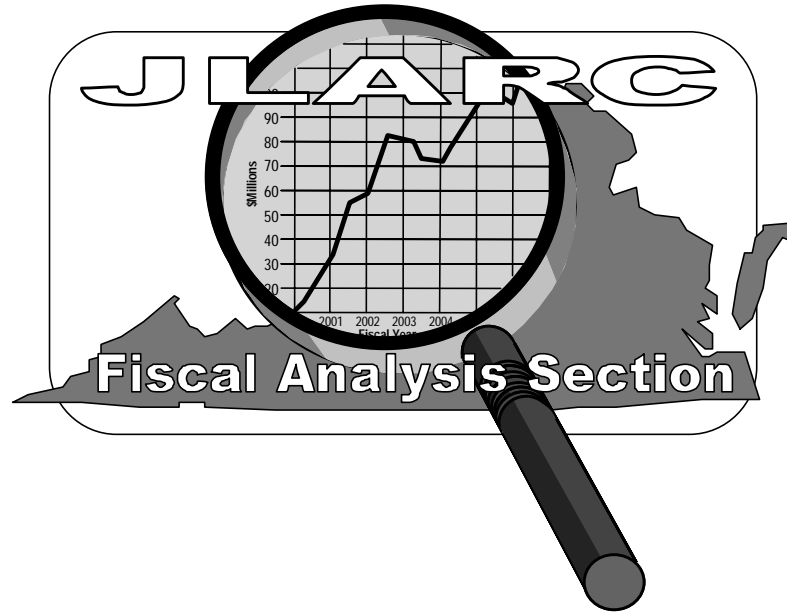


**Joint Legislative Audit and Review Commission  
of the Virginia General Assembly**



**Special Report:  
Tax Compliance**

**Staff Briefing  
October 15, 2002**

# Presentation Outline

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2

- ☒ **Background**
- ☐ **Compliance and Enforcement Issues**
- ☐ **Tax Amnesty**
- ☐ **Other Matters**
  - **Set-off Debt Collection**
  - **Filing Forms**
  - **Calculating the Tax Gap**

# Study Mandate

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- In July 2002, JLARC asked staff to examine the effectiveness and efficiency of Virginia's tax collection process
- JLARC members also asked for specific follow-ups:
  - The pros and cons of a tax amnesty program
  - The effectiveness of set-off debt collection requirements
  - Whether there is a statutory barrier to requiring taxpayers to file directly with the Department of Taxation (TAX)

# Background

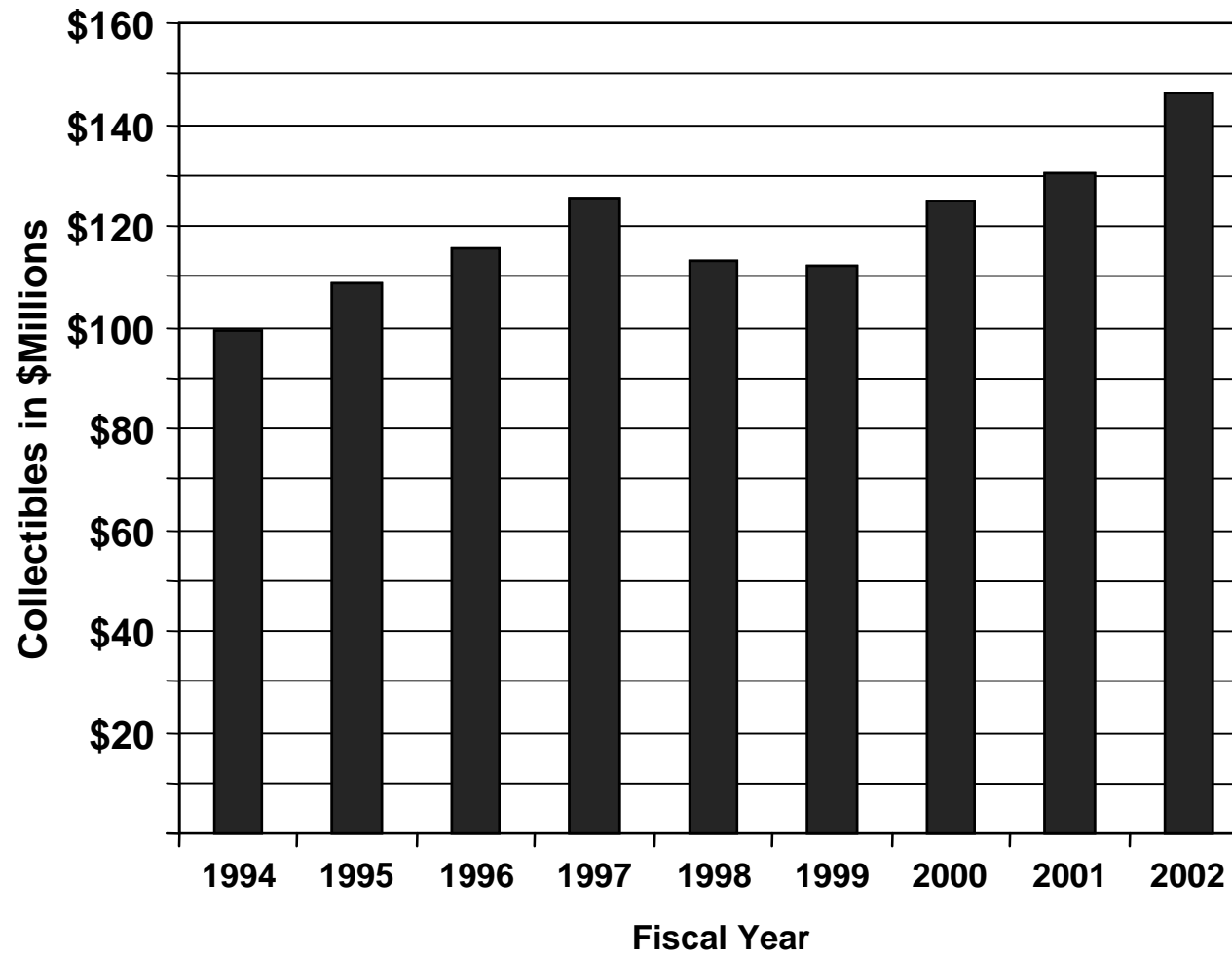
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## ■ Factors suggesting a need to look at tax compliance:

- Diminished State general fund revenue
- 30 percent increase in TAX's accounts receivable
- Virginia's decision to "de-conform" from federal tax code, at least until 2003
- According to the IRS and GAO, tax evasion is on the increase
  - IRS Commissioner estimated \$207 billion in federal taxes go unpaid

# Trend in Tax Collectibles

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# **1991 JLARC Review of Virginia Department of Taxation**

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- **The Appropriation Act directed JLARC to review the organization, management, operations of TAX**
  - **Reported a “tax gap” of more than \$500 million between what was owed and what was paid to the Commonwealth**
  - **Noted that, in a VCU survey, 6 percent of Virginia respondents said they may have overstated deductions or expenses**
  - **Found that additional revenue could be collected with improved management and more efficient use of compliance staff**
  - **Recommended significant improvements in State Tax Accounting and Reporting System (STARS), better internal accountability and external oversight**

# Improvements Since 1991 JLARC Report

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- Improved strategy for selecting and auditing returns
- Improved use of external and third party databases to identify non-filers
- Entered a partnership with a technology firm (American Management Systems) to upgrade agency information systems
  - For four years ending FY2002, AMS was paid \$98.7 million. According to TAX, this was entirely new revenue
  - The Commonwealth will receive these new revenues after the AMS contract is completed – expected in 2004

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8

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# Compliance Staffing

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- **The number of tax auditors declined 31 percent, from 236 in FY 1995 to 164 in FY 2002**
- **Workload has increased**
  - Number of individual returns has increased 17.4 percent, corporate returns have increased 11.5 percent
  - Total individual tax liabilities have increased 67 percent
- **Productivity has improved**
  - Enforcement-related collections increased 18 percent, from \$263 million in FY 1995 to \$310 million in FY 2002 (excluding AMS revenues)
    - TAX began using outside collection agencies in 1996; in FY 2001 they collected \$23 million

# Staffing and Workload Trends

		Millions			
	Office & Field Audit Staff	Individual Returns Filed	Indiv. Income Tax Liabilities	Corporate Returns Filed	Sales Tax Dealers
<b>FY 1995</b>	<b>236</b>	<b>2.70</b>	<b>\$4,028.1</b>	<b>131,860</b>	<b>139,032</b>
<b>FY 1996</b>	<b>225</b>	<b>2.74</b>	<b>4,348.0</b>	<b>137,964</b>	<b>140,490</b>
<b>FY 1997</b>	<b>214</b>	<b>2.82</b>	<b>4,727.8</b>	<b>142,613</b>	<b>141,909</b>
<b>FY 1998</b>	<b>199</b>	<b>2.86</b>	<b>5,405.4</b>	<b>148,428</b>	<b>147,775</b>
<b>FY 1999</b>	<b>190</b>	<b>2.95</b>	<b>6,087.9</b>	<b>151,948</b>	<b>142,881</b>
<b>FY 2000</b>	<b>182</b>	<b>3.02</b>	<b>6,828.9</b>	<b>150,536</b>	<b>141,868</b>
<b>FY 2001</b>	<b>179</b>	<b>3.11 (preliminary)</b>	<b>7,226.3</b>	<b>147,085</b>	<b>139,954</b>
<b>FY 2002</b>	<b>164</b>	<b>3.17 (estimated)</b>	<b>6,710.8</b>	<b>N/A</b>	<b>138,706</b>
<b>Percent Change</b>	<b>-30.5%</b>	<b>+17.4%</b>	<b>+66.6%</b>	<b>+11.5% (FY95-FY01)</b>	<b>(-0.2%)</b>

# **Additional Compliance Staff Could Increase Revenues**

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## **■ Additional staff could increase revenue collection (illustrative examples:)**

- If TAX had achieved this productivity level with the same number of auditors as in FY 1995, approximately \$125 million more revenue could have been collected**
- Using the \$4 collected for every \$1 expended ratio suggested by TAX, adding 72 compliance staff at a cost of \$4.3 million might generate \$17.3 million in new revenue**

# Recommendation

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- **The General Assembly may wish to authorize the Department of Taxation to employ additional field and office audit staff.**

# Authority of Criminal Investigation Unit

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- Established by 1989 legislation, the unit now has five employees who investigate allegations of tax evasion and fraud
- Two important constraints on the unit:
  - Lacks direct access to criminal history records
  - Penalty for failure to file and filing false return is misdemeanor, not felony

# Unit Needs Access to Criminal Records

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- ***Code of Virginia* §19.2-389 limits access to criminal history database to listed entities, including**
  - Lottery Department
  - Charitable Gaming Commission
  - DMV
  - State Corporation Commission
  - Board of Elections
  - ABC
- **Access would provide TAX with ability to determine background of persons being investigated, improving effectiveness of investigations**

# Penalty for Failure to File Is Modest

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- Virginia's penalty for failure to file a tax return is modest
  - Class 1 misdemeanor (Up to \$2,500 fine and 12 months jail)
  - Same penalty as *petit* larceny, theft of under \$200
  - Same penalty for corporate and individual tax statutes
- Average personal and corporate income tax liability exceeded \$2,350 in 2001 (net of refunds)
- Department staff indicate this modest penalty hinders investigations
- Stronger penalty would improve fairness

# Failure-to-File Penalties in Other States

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## ■ Felony

- North Carolina
- Tennessee
- Kentucky
- Federal

## ■ Misdemeanor

- West Virginia
- Maryland
- D.C.



# Recommendation

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- **The General Assembly may wish to authorize the Department of Taxation to have access to criminal history records maintained by the Department of State Police, for purposes of conducting investigations under the tax laws of Virginia. This could be implemented by adding the Department of Taxation to the list of agencies with such access included in §19.2-389 of the *Code of Virginia*.**

# Recommendation

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- The General Assembly may wish to make it, as a maximum penalty, a felony offense to fail to file or to willfully refuse to file an income tax return, and for filing a false return. This would require amending *Code of Virginia* §58.1-348 as well as related filing statutes.
- Should the prior recommendations be adopted, the Department of Taxation should undertake a significant effort to publicize them. A combination media, internet, and mass mail campaign should be considered.

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19

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# Tax Amnesty Programs

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- These programs waive, for 60-90 days, all or a portion of penalties and interest on overdue taxes
- Amnesty provides:
  - A “last chance” to pay prior to increased penalties and enforcement, and
  - Opportunity for the State to receive revenue that would otherwise be costly to collect, if collected at all
- 40 states have had an amnesty since 1982
  - Virginia had an amnesty in 1990, collecting \$32.2 million
  - 10 states have had tax amnesties in 2002

# **Tax Amnesty Key Benefits**

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- **Accelerate revenue into a specified year**
  - **JLARC staff estimates, using the per capita amounts received during Virginia's 1990 tax amnesty, a one-time yield of about \$51 million. Actual collections could vary.**
- **Increase public acceptance of stronger enforcement of existing tax laws**
  - **Virginia's earlier amnesty was part of legislation that increased penalties, established a criminal investigation unit in TAX, authorized the Commissioner to "padlock" seriously delinquent businesses**

# Tax Amnesty Key Concerns

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- **Appears to excuse or overlook failure to comply with tax laws**
  - Can be addressed by rarely offering amnesty, and then only together with enhanced enforcement and stiffer penalties
    - Virginia's only amnesty was in 1990
  - Amnesty program can be crafted to reduce, not eliminate, penalties or interest and still provide incentive to apply for amnesty
    - Ohio only reduced penalties 50 percent
    - Connecticut only reduced the interest rate by 25 percent
    - Kentucky imposed a 20 percent penalty (on top of all others) on taxpayers who ignore amnesty and are subsequently caught

# **Tax Amnesty Key Concerns**

## **(continued)**

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- **Amounts owed by delinquent taxpayers would be collected eventually, without an amnesty**
  - **Amnesty programs are designed to collect past-due taxes in a specific period of time**
  - **Due to staffing limitations and increasing workloads, the chance of evading payment may be increasing, according to IRS and GAO**
- **Department of Taxation disagrees with the benefits of a tax amnesty**

# Tax Amnesty Recommendation

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- **The General Assembly may wish to authorize a 60-day tax amnesty period. The amnesty may be modeled on the 1990 Virginia amnesty, which provided that all non-filers and those with assessments outstanding (excluding those under investigation or prosecution for filing a fraudulent return or for failing to file) would be eligible for the amnesty. Penalties and interest could be reduced or eliminated during the amnesty period.**



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25

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# Set-off Debt Collection

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26

- In response to a JLARC recommendation, the General Assembly in 1982 enacted a procedure for using tax refunds as an automatic offset for any debts owed by taxpayers to the State
  - Includes child custody payments, college tuition and fees, court fines
  - These debts are offset by tax refunds, lottery winnings, etc
- Since the program began, more than \$282 million has been collected in this manner
  - \$29.9 million collected in 2002; \$12.1 million was for debts to local agencies
  - Nearly 800 State and local agencies participate

# Filing Tax Forms

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- **Concern: People are directed to file forms with local commissioners of revenue, not the State Tax Department**
  - *Code of Virginia* §58.1-306 bars the department from promoting or soliciting income tax returns unless requested by a local official. To date, 18 jurisdictions have so requested.
  - Taxpayers may voluntarily choose to mail returns direct to TAX, to telefile (via telephone), e-File (by internet via the IRS), or iFile (internet filing directly with TAX)
- **In 2002, 71 percent of all income tax returns were filed directly with TAX, up from 59 percent in FY 1998**

# Calculating the Tax Gap

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- **The prior JLARC report noted that the IRS and other state tax departments estimated the difference between what is collected and what taxpayers actually owe**
  - **Virginia had not done so; JLARC staff calculated the gap as more than \$512 million in 1992**
    - **TAX's accounts receivable, evidence of "cumulative remittance gap," was \$404 million in 1991**
    - **As of March 31, 2002, TAX's receivables stood at \$967.3 million, with \$146 million deemed "collectible"**

# Recommendation

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- **The Department of Taxation should develop a methodology for estimating the tax gap, and report its estimate on a regular basis to the House Finance and Senate Finance committees.**